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SUBJECT: ChinaQs NDRC Urges Expanded Fiscal Stimulus, Economic Rebalancing, and Exchange Rate Stability

¶1. (SBU) Summary. Rapidly increasing government spending and a decline in tax revenue caused by the economic slowdown will drive ChinaQs central and local government fiscal deficits to about 2.5 percent of GDP in 2009, compared to about 0.5 percent in 2008 and the highest level since 2002. National Development and Reform Commission (NDRC) Director General Xu Lin believes China can and should expand its fiscal stimulus, as lower interest rates are unlikely to spur greater investment and exchange rate policy cannot significantly boost exports. Also, China needs to rebalance economic growth toward domestic demand-led and services-led growth. Xu said the PeopleQs Bank of China (PBOC), ChinaQs central bank, is finding it difficult to convince commercial banks to lend to enterprises, given the uncertain economic outlook. At the same time, he claimed the China Banking Regulatory Commission (CBRC) is tightening prudential requirements due to rising credit risk concerns. Xu believes the central government is likely to keep the RMB stable vis-a-vis the U.S. dollar in the near term, with only limited volatility. NDRC is encouraging other Chinese regulators to adopt various bond market reforms. Finally, Xu said Chinese officials questioned the timing of former U.S. Treasury Secretary PaulsonQs remarks on global imbalances in his recent interview with the QFinancial TimesQ newspaper. End Summary.

Fiscal Stimulus Boosts Spending ...

¶2. (SBU) On January 21, NDRC DG Xu told Econ and Finance Minister-Counselors that in 2009 ChinaQs central government will run a fiscal deficit of approximately RMB 600 billion (USD 88 billion), while local government deficits will total about RMB 200 billion. This will bring the combined 2009 central and local fiscal deficit to about 2.5 percent of GDP, compared to the 2008 deficit of about 0.5 percent of 2009 GDP. (Note: Although somewhat above 2007-08 levels, the combined 2009 central-local deficits as shares of GDP are comparable to 2000-03 levels. Also, while local governments technically are not permitted to run deficits, in practice they frequently do so, in part because their budget allocations for succeeding years are based on expenditures during current years. End note.) Local governments will finance one-third of their increased economic stimulus spending through deficit financing, with the remainder funded through local government revenues and bonds issued by local government corporations. The Ministry of Finance (MOF) will issue bonds on behalf of local governments, and MOF also may allow local governments to issue their own bonds.

¶3. (SBU) The central government generally requires most infrastructure projects to have equity capital, but as a temporary measure to promote financing of public infrastructure development, it allows long-term bank loans to constitute up to 40% of the equity. (Comment: Several large state-owned bank representatives previously told Finatt that they can increase lending to public infrastructure projects prudently while limiting credit risks, because most projects require significant equity as capital. It now appears that up to 40% of this supposed equity cushion could be the banks' own loans. End comment).

... While Tax Revenues Are Falling

¶4. (SBU) Tax revenues declined 11% year on year (y/y) in December and Xu forecasts they will continue to drop in the first quarter of 2009, on a y/y basis. For all of 2009, he expects tax revenues to grow about eight percent, slightly less than nominal GDP growth of 10-12 percent. He estimates that tax cuts enacted as part of the fiscal stimulus package (i.e., making capital goods purchases eligible for VAT rebates) will reduce revenues by RMB 300 billion (one percent of GDP), although the increased VAT rebates will provide only modest support for exporters due to falling external demand.

¶5. (SBU) Xu believes China can and should expand the fiscal stimulus. Monetary policy is in a "liquidity trap" with lower interest rates unlikely to spur greater investment, given current excess capacity and weak

demand. Exchange rate policy cannot significantly boost exports; even if it could, China needs to rebalance economic growth toward domestic demand-led growth. With a low (20-22 percent) debt-to-GDP ratio, China can finance bigger deficits without raising concerns about the sustainability of public finances. Xu said the NDRC has more worthy projects to finance, but the Ministry of Finance (MOF) is reluctant to allow a larger fiscal deficit. Xu suggested that the U.S. should urge other G-20 countries with current account surpluses to pursue greater fiscal stimulus.

Crisis Promotes Rebalancing

¶6. (SBU) Xu estimates that absent the fiscal stimulus, ChinaQs real GDP growth rate for 2009 would fall to five percent. As a result of the financial crisis, he said China will intensify its efforts for more domestic demand-led and services-led growth. Shrinking financial sectors in developed countries will give manufacturing greater relative weight in their economies, and will increase competition for ChinaQs manufacturers. One way for China to promote development of services would be to eliminate state monopolies and allow private investment in some sectors.

Mixed Messages on Bank Lending

¶7. (SBU) While the PeopleQs Bank of China (PBOC) has the capability to inject sufficient liquidity into the banking system, Xu stated, it may be difficult to persuade banks to lend to commercial enterprises, given the uncertain economic outlook. In contrast to efforts to boost credit by the PBOC -- which faces political pressure from local government officials in the run up to this spring's National People's Congress -- the China Banking Regulatory Commission (CBRC), concerned about rising credit risks, is tightening its prudential requirements. (Note: In a mid-February meeting, however, the PBOC told us that CBRC had relaxed somewhat its policy on non-performing loans (septel). End note.)

Exchange Rate Stable

¶8. (SBU) Xu believes the Central Government is likely to keep the RMB stable vis-a-vis the U.S. dollar in the near term, with only limited volatility. Increasing external price competitiveness through depreciation would have little impact on exports due to weak external demand. As noted above, he thinks China needs to reorient its economy towards more domestic demand-led growth, as the financial crisis has made clear it can no longer rely on external demand for robust growth. Given that change in the world economy, there would be no reason to risk damage to relations with trading partners through depreciation, which would bring limited benefit for the Chinese economy.

Bond Market Developments

¶9. (SBU) Xu said enterprise bonds regulated by the NDRC can be traded on both the (PBOC-regulated) interbank bond market and the bond exchange regulated by the China Securities Regulatory Commission (CSRC). To increase liquidity, the NDRC is encouraging both CSRC and PBOC to establish a unified trading platform for both markets, which Xu expects will occur this year. He believes the problem with the interbank bond market is that most investors are banks, so it does not offer an alternative to the banking system. As there are too few long-term institutional investors, NDRC is lobbying the China Insurance Regulatory Commission (CIRC) to allow insurance companies to hold bonds that do not have bank guarantees. Finally, Xu said the NDRC is working to allow foreign enterprises to issue RMB bonds; Wal-Mart and General Electric are potential candidates.

Paulson Comments on Global Imbalances: Poorly Timed
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¶10. (SBU) According to Xu, Chinese officials questioned the timing of former U.S. Treasury Secretary PaulsonQs remarks on global imbalances in his recent interview with the QFinancial TimesQ newspaper. Xu said some officials wondered why he had raised this issue in his final days

in office. (Comment: Paulson had raised similar concerns over the course of 2008. End comment). Xu opined that rather than argue about the causes of the financial crisis, officials should to take joint actions to ameliorate its impact.

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